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Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

NUMBER 608

MILTON H. FRIEND, BERTHA F. LEVY AND ETHEL PACYNA, AS TRUSTEES OF THE TRUST ESTATE CREATED UNDER THE LAST WILL AND TESTAMENT OF HENRY FRIEND, DECEASED,

Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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MILTON H. FRIEND, BERTHA F. LEVY AND ETHEL PACYNA, AS TRUSTEES OF THE TRUST ESTATE CREATED UNDER THE LAST WILL AND TESTAMENT OF HENRY FRIEND, DECEASED,

Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Milton H. Friend, Bertha F. Levy and Ethel Pacyna, as Trustees of the Trust Estate created under the Last Will and Testament of Henry Friend, Deceased, by A. J. Pflaum and Harry N. Wyatt, their counsel, pray that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit in the above case.

Jurisdiction.

The jurisdiction of this Court is invoked under § 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229, § 1, 43 Stat. 938; 28 U. S. C. A. § 347.

The judgment herein sought to be reviewed is a decision of the United States Circuit Court of Appeals for the Seventh Circuit, entered February 26, 1941 (R. 216-17). A petition for rehearing was denied June 13, 1941 (R. 217).

Questions Presented.

1. Does the Revenue Act of 1934 provide a basis for depreciation of property acquired by bequest, devise or inheritance or by the decedent's estate from the decedent?

2. The executors of the Will of Henry Friend, deceased, acquired from said Henry Friend upon his death the lessor's interests in certain long term leases covering land and buildings in Chicago. These leases provided for fixed annual rentals substantially in excess of the fair rental value of the land at the time of the decedent's death, and for that reason the lessor's interests in the leases had a fair market value at that time substantially in excess of the fair market value of the unencumbered fee simple in the land. Respondent admitted at the hearing that, if the executors had purchased said lessor's interests at their then fair market value, such excess would be an exhaustible capital asset, returnable (free from income tax) by annual deductions spread over the terms of the leases, and that the only question in this case is whether or not, under the applicable revenue act, such excess values of the leaseholds, when acquired by inheritance, have a basis for depreciation or for exclusion from income as return of capital, equivalent to that in the case of purchase. Under these circumstances do §§ 22, 23, 113 and 114 of the Revenue Act of 1934 provide a basis for depreciation or return of capital equal to the excess value of the lessor's interests in such leaseholds over the unencumbered land on the date of the decedent's death?

Statement of the Matter Involved.

On August 1, 1932, when Henry Friend died, he was the owner of the fee in two certain pieces of real estate in Chicago, namely, 6308-10 and 6312-14 South Halsted Street, and also of the lessor's interests under leases of those properties, the former for approximately 87 years with S. S. Kresge Company and the latter approximately 41 years with F. W. Woolworth Co. The rentals provided in these leases being substantially higher than the current rental value of the land on August 1, 1932, the fair market value of the fees plus the lessor's rights to rents under the leases, received by the decedent's estate from the decedent, was substantially greater than the fair market value of the land alone.

The executors of the decedent's estate claimed the right to take annual deductions from the gross income of these properties (for convenience collectively referred to as the "Halsted properties") for income tax purposes, as depreciation, amortization or exhaustion of these excess values. These deductions were disallowed by the respondent for the calendar years 1934 and 1935, and the Commissioner's disallowance has been affirmed by the United States Board of Tax Appeals and the United States Circuit Court of Appeals for the Seventh Circuit.

The opinion of the Circuit Court of Appeals relies in its affirmance of the disallowance upon the fact that the executors did not have a "cost" for these excess values—did not pay out a valuable consideration therefor,—thus differentiating property acquired by inheritance from that acquired by purchase. In addition, the Circuit Court of Appeals (overlooking entirely Section 114 (a) of the Revenue Act of 1934) ruled that property acquired by inheritance had a basis solely for the purpose of determining *gain or loss* for income tax purposes in the event of a future sale, and not for *depreciation*.

Reasons for Allowance of the Writ.

This writ is sought on the ground that: The Circuit Court of Appeals erred in deciding that exhaustible property acquired by a decedent's estate from the decedent does not have a basis for depreciation by reason of such acquisition under the Revenue Act of 1934, and that the proceeds from such exhaustible property constitute income to the decedent's estate when received without exclusion or deduction of the value thereof on the date of the decedent's death as return of capital or as depreciation, amortization or exhaustion. This is a decision of a Federal question in conflict with the applicable decisions of this Court, and in conflict with the decisions of at least four other Circuit Courts of Appeals, and is contrary to the unmistakable language of the revenue laws and rules and regulations thereunder.

Hartley v. *Commissioner,* 295 U. S. 216, 79 L. Ed. 1399 (1935), affirming 72 F. (2d) 352, 353, 356, 14 A. F. T. R. 444 (C. C. A. 8th 1934).

Burnet v. *Logan,* 283 U. S. 404, 413-414, 75 L. Ed. 1143 (1931).

Commissioner v. *Dobbins,* 72 F. (2d) 984, 985, 14 A. F. T. R. 545 (C. C. A. 3rd 1934).

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Burnet v. *Hanlon,* 51 F. (2d) 463, 465, 10 A. F. T. R. 267 (C. C. A. 4th 1931).

This reason is further and more fully developed in the brief in support hereof, annexed hereto.

All of which is respectfully submitted.

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BRIEF IN SUPPORT OF PETITION.

Opinions Below.

The opinion of the United States Board of Tax Appeals, written by Member C. P. Smith (R. 180-92), is reported at 40 B. T. A. 768. The opinion of the Circuit Court of Appeals is by Circuit Judges Evans and Major and District Judge Lindley (Judge Major writing) (R. 213-16) and is reported at 119 F. (2d) 959.

Statement of Jurisdiction.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (c. 229, § 1, 43 Stat. 938; 28 U. S. C. A. § 347), to review a decision of the United States Circuit Court of Appeals for the Seventh Circuit, entered February 26, 1941 (R. 216-17). A petition for rehearing was denied June 13, 1941 (R. 217).

Statement of the Case.

A concise statement of the case is set forth in the foregoing petition (page 3), and is not repeated here.

Specification of Errors To Be Urged.

The Circuit Court of Appeals erred:

1. In holding that exhaustible property acquired from a decedent by his estate has no basis for depreciation, and that the estate is not entitled to annual deductions from income for income tax purposes by reason of the exhaustion of such property.

2. In ignoring the applicability of Section 114 (a) of the Revenue Act of 1934 (when coupled with Section 113 (a) (5) of that Act) to exhaustible property acquired from a decedent by his estate.

ARGUMENT.

The Basis for Depreciation or Return of Capital of Exhaustible Property Acquired by a Decedent's Estate From the Decedent Is Its Value on the Date of Decedent's Death.

Respondent and the Circuit Court of Appeals have both recognized that a lessor's rights to receive rents are exhaustible assets and that where such rights have a *cost*, such cost may be written off by annual deductions over the life of the rights. The only question presented to this Court is whether or not such rights, when inherited, have a basis which is the equivalent of cost for purposes of such annual deductions. It is believed that, in holding that no such basis existed, the Circuit Court of Appeals cannot have had the pertinent provisions of the Revenue Act of 1934 in mind. These provisions are as follows:

Section 23 (l) provides in general terms for depreciation deductions. It is quoted in full in the footnote.[1]

Section 23 (n) provides:

> "(n). BASIS FOR DEPRECIATION AND DEPLETION.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

---

1. "Sec. 23. DEDUCTIONS FROM GROSS INCOME.
"In computing net income there shall be allowed as deductions:
* * *
"(l) DEPRECIATION.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."

In Section 114 (a) the basis for depreciation is made the same as the basis for gain, as follows:

> "Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.
>
> "(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property."

It will be noted that Section 114 (a) makes no distinction between the basis fixed in Section 113 by purchase and the basis fixed in Section 113 by death, by gift, or in any other manner.

Section 113 (b) of the Revenue Act of 1934, referred to in Section 114 (a), merely adopts the basis fixed in Section 113 (a) with certain adjustments, none of which is here applicable.[2]

Section 113 (a) (5) provides in part as follows:

> "If the property was acquired by bequest, devise or inheritance or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. * * *"

It has never been doubted that the effect of Section 114 (a) is to make exactly the same rules for basis applicable to depreciation as are applicable to gain. This is specifically stated in Article 114-1 of respondent's Regulations 86, promulgated under the Revenue Act of 1934, as follows:

> "Art. 114-1. Basis for allowance of depreciation and depletion.—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, * * *."

---

2. Section 113 (b) provides in part as follows:

"Sec. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * *

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. * * *"

The complete texts of Sections 113 and 114(a) and the pertinent provision of Section 114(b) of the Revenue Act of 1934 appear in the appendix.

There is nothing in the words or purpose of the statute or regulations and nothing in any decision or ruling which in any way denies that the basis defined in Section 113 (a) (5) as the date-of-death value of property received by inheritance is appropriate for purposes of determining depreciation of such property.

The Report of the Ways and Means Committee of the House of Representatives concerning the Revenue Act of 1924 (68th Cong., 1st Sess., H. Rept. 179) discussed Section 204 (c) of the 1924 Act (which was the original statutory forerunner of Section 114 (a) quoted above) as follows (1939-1 C. B. (Part 2) 254):

> "(9) The first part of subdivision (c) of the bill, that is, the part preceding the exceptions, does not correspond to any provision of the existing law, but is the same as the interpretation placed upon the existing law by the Department. It provides that *the basis of computing depreciation and depletion shall be the same as the basis of computing gain or loss from the sale of property, and represents what is obviously the correct rule,* since the theory in setting a basis for depreciation and depletion is the same as in setting one for determining gain or loss from sale; that is, *to insure a taxpayer a return of his capital free from tax.*" (Italics supplied.)

The House Ways and Means Committee Report concerning Section 114 (a) of the 1934 Act involved in this case summarily stated substantially the same rule previously stated by the Committee under the 1924 Act (73rd Cong., 2d Sess., H. Rept. 704, 1939-1 C. B. (Part 2) 575):

> "Section 114. Basis for depreciation and depletion: Subsections (a) and (b) (1) prescribe as the general basis for computing depreciation and depletion allowances, the basis for determining gain upon the sale or other disposition of property."

That the decision of the Circuit Court of Appeals in the case at hand is in conflict with these statutory provisions

appears clearly from the following quotation from the opinion (R. 214-15):

> "The respondent admits that the cost of acquiring a leasehold is an exhaustible capital investment returnable by annual deductions spread over the term of the lease. *Boos* v. *Commissioner*, 30 B. T. A. 882. But the respondent denies that there has been any *cost* to the estate in the acquisition of these leases, and consequently there can be no loss to be recovered by amortization or depreciation.
>
> "Depreciation allowances are limited to depreciable property and exclude assets not of that character. *Paducah Water Co.* v. *Commissioner*, 33 F. (2d) 559. These allowances, when permitted are deductible by the entity that has acquired the asset at some 'cost,' meaning capital expenditure, or other valuable consideration. *Weiss* v. *Wiener*, 279 U. S. 333; *Commissioner* v. *Terre Haute Elec. Co.*, 67 F. (2d) 697. • • •
>
> "It is also suggested that Section 113 (a) (5) of the Revenue Act of 1934 (26 U. S. C. A. Sec. 113) will operate to furnish a cost or other basis which may be amortized by the petitioners. • • • *It is plain from a reading of the statute that what is meant is to give the asset, whatever it may be, a basis for valuation for the purpose of determining gain or loss for income tax purposes in the event of a future sale of the asset.* The statute can not be construed, even in conjunction with the valuation for estate tax purposes and the payment of that tax, to place the petitioners in the position of a purchaser of the leaseholds for a valuable consideration. Therefore, the contention of the petitioners must fail, and their other contentions must fall with it." (Italics supplied.)

It will be noted that the Court has omitted all reference to Section 114 of the Revenue Act of 1934, which is the section that makes Section 113 (a) (5) applicable to depreciation as well as to gain or loss. The refusal to permit depreciation of a basis acquired upon inheritance is contrary to the express provision of the statute.

Equally clear is the conflict between the decision of the

Circuit Court of Appeals herein and the decisions of this Court and the Courts of other Circuits.

In *Hartley* v. *Commissioner*, 72 F. (2d) 352, 353, 356, 14 A. F. T. R. 444 (C. C. A. 8th 1934), the court was concerned with the basis of inherited property, both for gain or loss and for depreciation, as shown by its following statement (72 F. (2d) at 353):

> "This point is whether in estimating property gains and losses from sales of property and depletion or depreciation of such properties the basic value is that of acquisition cost to the testator or of value at death of the testator."

The court discussed the two questions together without distinction and decided both in the following language (72 F. (2d) at 356):

> "We must conclude that the Board correctly affirmed the action of the Commissioner in taking value at time of death of Hartley as the basis for estimating gain or loss on sales, during these tax years, by the executor of property belonging to the estate. For the same general reasons, estimates of depreciation or depletion of such properties should be upon the same value basis."

Upon petition for certiorari by the executor of the Hartley estate, the United States Supreme Court unanimously affirmed the decision of the Circuit Court of Appeals in *Hartley* v. *Commissioner*, 295 U. S. 216, 79 L. Ed. 1399 (1935).

In the *Hartley* case the question was almost identical with the question here involved, except that the positions of the Commissioner and the taxpayer were reversed. In the present case the Commissioner takes the position that, since the leases were entered into by the decedent, Henry Friend, without cost, there is no *basis*, in the decedent's estate, for depreciation of the exhaustible excess values in the leases. In other words, the Commissioner apparently argues that basis for depreciation of inherited property is

determined by cost to the decedent rather than by value at the date of death. In the *Hartley* case it was the taxpayer who argued that cost to the decedent was controlling, and the Commissioner who argued for value on the date of death. This Court held specifically that for purposes of depreciation and depletion, as well as for purposes of gain or loss, the basis is the value on the date of death, and not cost to the decedent. This Court stated as follows (295 U. S. 217):

> "The Court of Appeals for the Eighth Circuit * * * affirmed a ruling of the Board of Tax Appeals * * * and held that * * * the basis for computing gain or loss on the sale of property, *and its depletion or depreciation,* for purposes of taxing income returned by the petitioner, an executor, is its value at the date of the decedent's death, rather than the cost to the decedent, or the value on March 1, 1913, if acquired before that date." (Italics supplied.)

This Court affirmed the Circuit Court of Appeals and the Board of Tax Appeals, stating at pages 217-18 and 219-20 as follows:

> "* * * Sections 202 (a), (b) and 214 (a) (8), (10) of the 1921 Act, and §204 (a), (b), (c) of the Revenue Acts of 1924 and 1926, chap. 27, 44. Stat. at L. 9 U. S. C. title 26, §935, provide that the basis for computing gain or loss on the sale of property, and depreciation and depletion, shall be its cost, or its value on March 1, 1913, if acquired before that date. None of the acts specifically provides a basis for making the computations where return is made of income received by the estate of a decedent in the course of administration. But in the case of property acquired by 'bequest, devise, or inheritance' §202 (a) (3) of the 1921 Act and §204 (a) (5) of the 1924 and 1926 Acts provide that the basis shall be the fair market value 'at the time of acquisition'.
>
> * * * * *
>
> "* * * The conclusion seems inescapable that the intended date of acquisition by an executor or admin-

istrator, where the estate is the taxpayer, is the date of the decedent's death. Brewster v. Gage, 280 U. S. 327, 335, 74 L. ed. 457, 461, 50 S. Ct. 115."

At the time the *Hartley* case arose there was no provision in the Revenue Acts corresponding to Section 113 (a) (5) quoted on page 8 above. In this connection, however, this Court held as follows (220-21):

> "* * * The incorporation of the regulation in §113 (a) (5) of the 1928 Act was intended to clarify, but not to change the law. See Report of House Committee on Ways and Means, No. 2, 70th Cong., 1st Sess., p. 18; Report of Senate Committee on Finance No. 960, 70th Cong., 1st Sess., p. 26; Report of Joint Committee on Internal Revenue Taxation, H. R. Doc. 139, 70th Cong., 1st Sess., pp. 17, 18."

The principle underlying the right granted to taxpayers to deduct from gross income amounts in respect of depreciation or exhaustion of property is that the gross receipts from depreciable property are not really *gains* or *profits* in their entirety. In substance the right to take the deductions in respect of exhaustible assets is designed to recognize such amounts as *returns of capital.* This was originally and has continued to be the foundation for the allowance of the deduction. As stated in the report of the Ways and Means Committee on the Revenue Act of 1924, quoted on page 9 above:

> "* * * the theory in setting a basis for depreciation * * * is, to insure a taxpayer a return of his capital free from tax."

The principle is the same, whether the amounts involved are treated as depreciation deductions or as exclusions from income. In both cases it is the intent of the statute to exclude from taxation amounts which represent a return of capital. This applies not only to property acquired for a valuable consideration but also to property acquired by inheritance.

Section 22 (b) (3) of the Revenue Act of 1934 requires

the exclusion from income of "the value of property acquired by gift, bequest, devise or inheritance."[3] The amount thus excluded is identical in the case of exhaustible property with the amount which may be written off by depreciation deductions pursuant to Sections 23 (l), 114 (a) and 113 (a) (5).

The refusal of the Circuit Court of Appeals to recognize the right of the executors herein to exclude from income amounts representing such return of capital in the case at hand is in conflict with the express decision of this Court in *Burnet* v. *Logan*, 283 U. S. 404, 413-14, 75 L. Ed. 1143, 1148 (1931). In the *Logan* case the taxpayer and the taxpayer's mother had transferred stock in one corporation to another corporation in return for certain cash and the right to receive cash payments for a limited period. Subsequently, the taxpayer's mother died and the taxpayer inherited the rights to receive the periodic payments which had been acquired by the mother. The United States Supreme Court held that the taxpayer was entitled to a return of her cost (with respect to her own rights to receive periodic payments) and of the estate tax value (with respect to her mother's similar rights) before any of the receipts in question could be taxed as income. The Supreme Court stated as follows:

> "From her mother's estate Mrs. Logan obtained the right to share in possible proceeds of a contract thereafter to pay indefinite sums. The value of this was assumed to be $277,164.50 and its transfer was so taxed. Some valuation—speculative or otherwise—was necessary in order to close the estate. It may never yield as much, it may yield more. If a sum equal to the

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3. "Sec. 22. GROSS INCOME.

* * * * *

"(b) EXCLUSIONS FROM GROSS INCOME.—The following items shall not be included in gross income and shall be exempt from taxation under this title: * * *

"(3) GIFTS, BEQUESTS, AND DEVISES.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income)."

value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here. The statute definitely excepts bequests from receipts which go to make up taxable income. See *Burnet* v. *Whitehouse*, 283 U. S. 148, 75 L. ed. 916, 73 A. L. R. 1534, 51 S. Ct. 374."

In the case at hand the rights of the executors to receive periodic cash payments under the lease contracts (to the extent of the excess over and above the fair market value of the land) were identical in nature with the rights to periodic payments in the *Logan* case and equally finite in amount and duration. The right to receive their date-of-death value without tax is established by the *Logan* case and the denial of that right by the Circuit Court of Appeals is in conflict with that decision.

In addition, it is submitted, the decision of the Circuit Court of Appeals is in conflict with the decisions of four other Circuit Courts of Appeals on the same matter, namely, the Third, Fourth, Fifth and Eighth.

In *Dobbins* v. *Commissioner*, 31 F. (2d) 935, 936, 7 A. F. T. R. 8645, 8646 (C. C. A. 3rd 1929), the taxpayer's husband had received by bequest the right to income from a certain trust during the life of his sister. Subsequently the husband died, bequeathing to the taxpayer, his wife, the right to the income for the period after his death until his sister's death. The court held in effect that, while the property which had gone into the trust had been owned in its entirety by the first decedent and consequently the income from the trust was taxable as income to the taxpayer's husband whose right to income had not arisen until the death of the first decedent, the separation of the right to income for a specified period from the rest of the trust property had been effected prior to the death of the husband, and

consequently the property which was subject to bequest by him and which was actually bequeathed to the taxpayer was not the property from which the income was derived but rather the mere right to income itself and this was the way it had been appraised for estate tax purposes by the Commissioner. Consequently the moneys received by the taxpayer were received not as income, although they constituted income distributions from the trust, but as a return of capital of the bequest received from her husband. The court stated:

> "The income from this trust was taxable to Murrell Dobbins and was included in his tax returns, but when he died this fixed income became a part of the corpus of his estate which he could dispose of by will just as he could dispose of any other property which belonged to him. This was the then opinion of the Commissioner, and so he had it appraised. The amount of its appraised value was based upon the expectancy of the life of Mary A. Dobbins, during which payments were to be made, and an estate tax was accordingly paid thereon.
>
> "The appraised value of $212,438.05, fixed for the purpose of estate taxes, was based upon the theory that this was part of the estate of Murrell Dobbins. While the fund here taxed might have been income to the estate of Murrell, it was a legacy in the hands of Emily M. Dobbins, received not from Edward T. Dobbins, or his estate, but from Murrell Dobbins, under the residuary provisions of his will, and as such it was not taxable to Emily. The estate tax, which it seems to us was rightly paid, is indefensible on any other theory. The appraisement was not mathematically correct, for it might have been increased or decreased. This depended upon the length of the life of Mary A. Dobbins. It was an estate of inheritance passing under the will of Murrell, payable in installments, and not in a lump sum, though it might have been sold as such by Emily. A legacy or bequest left by will is not taxable as income."

Several years later the Commissioner again sought to tax the same income to the legatee of the previous taxpayer who had also died, bequeathing to her children her right to the income from the trust acquired from her husband. The court again held that the amounts received by the legatee were not taxable income, in *Commissioner* v. *Dobbins*, 72 F. (2d) 984, 985, 14 A. F. T. R. 545, 546 (C. C. A. 3rd 1934), stating as follows:

> "The important thing is not to confuse income from inheritances with inheritances. The Commissioner, himself twice treated the value of the interest of Murrell in the trust as an inheritance or legacy by imposing the estate tax on that interest."

In *Rose* v. *Grant*, 39 F. (2d) 338, 8 A. F. T. R. 10494 (C. C. A. 5th 1930) the life tenant of a testamentary trust claimed a refund of income taxes based upon depreciation of certain buildings and other exhaustible portions of real estate which formed part of the corpus of the trust. The District Court held that the life tenant was entitled to deduct depreciation based upon the value of the exhaustible property on the date of the decedent's death, and this decision was affirmed by the Circuit Court of Appeals for the Fifth Circuit.

In *McCahill* v. *Helvering*, 75 F. (2d) 725, 15 A. F. T. R. 304 (C. C. A. 8th 1935) the Circuit Court of Appeals for the Eighth Circuit considered the amount of depletion deductible with respect to depletable property acquired by inheritance. As shown in Section 114 (b) (1) of the Revenue Act of 1934, quoted in the appendix hereto, the general rule for determining depletion is stated in the same terms as the general rule stated in Section 114 (a) for depreciation. Under both, the basis is the same as the basis for gain provided in Section 113. The rule was stated by the Circuit Court of Appeals at pages 726-27 as follows:

> "* * * The relevant substance of the statutes is that in the case of coal mines the taxpayer shall be

> allowed as deductions from gross income 'a reasonable allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations * * * of the Secretary.' And it is provided that the basis for depletion in the case of a coal mine acquired by specific devise 'shall be the fair market value of the property at the time of the death of the decedent.' "

The Circuit Court of Appeals held that depletion was allowable based upon the proven value of the depletable property as of the date of the decedent's death.

Burnet v. *Logan*, 283 U. S. 404, 75 L. Ed. 1143 (1931) was quoted and followed in *Peak* v. *Commissioner*, 80 F. (2d) 761, 17 A. F. T. R. 117 (C. C. A. 8th 1936). In that case the taxpayer received by inheritance the right to certain payments of income of a corporation pursuant to a contract entered into by the decedent. This right was valued at $700,000 as of the date of death. Actually the payments aggregated more than $700,000. It was conceded generally that $700,000 could be received free from income tax, and the only question involved was the right of the taxpayer to receive amounts in excess of $700,000 free from income tax. The Circuit Court of Appeals for the Eighth Circuit held, affirming the Board of Tax Appeals, that the date of death value of the contract rights controlled in the determination of the portion of the amounts received pursuant to the contract which constituted return of capital, and that income commenced to be realized immediately after the aggregate receipts equalled the date-of-death value.

In *Burnet* v. *Hanlon*, 51 F. (2d) 463, 465, 10 A. F. T. R. 267 (C. C. A. 4th 1931) the Fourth Circuit Court of Appeals stated as follows:

> "When the Revenue Act of 1921 was adopted, the Commissioner applied the same basis to the computation of allowances for depreciation as was applied in

> computing profits on the sale of property. A like uniform basis had previously prevailed. It was evidently the intention of Congress when the act was passed to recognize and approve this method of computation. As originally drawn, the statute made provisions for the same basis for allowance for depreciation as in cases of sale. These provisions were stricken from the bill merely because they were deemed as surplusage."

In the *Hanlon* case the question involved was the basis for depreciation of exhaustible property received by gift. This question is substantially identical with the question of the basis for depreciation of inherited property. Section 113 (a) (4) of the Revenue Act of 1934, immediately preceding Section 113 (a) (5) (applicable to inherited property) and its predecessor provisions in prior statutes provide that the basis for gain or loss of property transferred by gift prior to January 1, 1921 is the fair market value of the property at the date of acquisition, and the only provision which makes that basis applicable for depreciation is the same provision in Section 114 (a) which is shown above to be applicable to inherited property.

The authorities have consistently held that the basis for depreciation of gift property is the same as the basis for gain, namely, the fair market value on the date of gift.

Conclusion.

A diligent search has failed to disclose any decision or ruling supporting the interpretation by the United States Circuit Court of Appeals in the case at hand, and on the contrary, as noted above, that decision of the Circuit Court of Appeals is in conflict not only with the express provision of the statute but also with the decisions of this Court and of the Courts of Appeals of numerous other Circuits.

The issue is clear. The executors inherited—in addition to the fee simple interest in the land—rights to periodic

money payments having a fair market value concededly in excess of the fair market value of the land alone. This excess value of periodic payments is admittedly exhaustible and will terminate with the termination of the lease contracts under which the payments are made. The land is of course inexhaustible. This exhaustible excess value, as of the date of death, under the statute and the decisions should be receivable by the executors free from income tax, either as deductions for exhaustion or as return of capital.

The respondent concedes and so does the Circuit Court of Appeals that if cash had been paid for this exhaustible excess value, the return thereof without tax would be allowed. It is contended, however, that a difference exists between the case of persons who acquire such property rights by purchase and those who inherit them. This contention is contrary to the express language of the statute and all of the pertinent authorities.

The import of such a decision is tremendous. It extends not only to cases in the nature of annuities involving periodic contract payments, but also to other forms of exhaustible property such as buildings on inherited land. *The plain meaning of the decision of the Circuit Court of Appeals would deny the right of persons inheriting real estate to take any deduction for depreciation of buildings on that real estate.* It is submitted that the principle enunciated by the Circuit Court of Appeals is a flagrant denial of rights assured taxpayers by the plain unambiguous language of enactments by Congress and the decisions of this Court and of the Courts of Appeals of other Circuits thereunder.

It is submitted, moreover, that the denial of the right to receive such returns of capital free from tax is an extension of the meaning of income subject to taxation beyond the intent of the Sixteenth Amendment to the Constitution of

the United States as interpreted by the decisions of this Court.

The decision of the Circuit Court of Appeals is contrary to the applicable decisions of this Court and the other Circuit Courts of Appeals, as well as to the unmistakable language of the applicable statute, and it is necessary that the decision of the Circuit Court of Appeals be reviewed by this Court in order to avoid confusion resulting from conflict of decisions, as well as to avoid a patent injustice to the petitioners herein, which will continue for many years.

All of which is respectfully submitted,

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APPENDIX.

The complete texts of Sections 113 and 114 (a) and the pertinent provisions of Section 114 (b) of the Revenue Act of 1934 are as follows:

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

(1) INVENTORY VALUE.—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

(2) GIFTS AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds its impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information that the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner.

(3) TRANSFER IN TRUST AFTER DECEMBER 31, 1920.—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made.

(4) GIFT OR TRANSFER IN TRUST BEFORE JANUARY 1, 1921.—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

(5) PROPERTY TRANSMITTED AT DEATH.—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall

be the fair market value of such property at the time of such acquisition. In the case of property transferred in trust to pay the income for life to or upon the order or direction of the grantor, with the right reserved to the grantor at all times prior to his death to revoke the trust, the basis of such property in the hands of the persons entitled under the terms of the trust instrument to the property after the grantor's death shall, after such death, be the same as if the trust instrument had been a will executed on the day of the grantor's death. For the purpose of this paragraph property passing without full and adequate consideration under a general power of appointment exercised by will shall be deemed to be property passing from the individual exercising such power by bequest or devise.

(6) TAX-FREE EXCHANGES GENERALLY.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(7) TRANSFERS TO CORPORATION WHERE CONTROL OF PROPERTY REMAINS IN SAME PERSONS.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of

stock or securities of the transferee as the consideration in whole or in part for the transfer.

(8) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—If the property was acquired after December 31, 1920, by a corporation.—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

(9) INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in section 112(f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

(10) WASH SALES OF STOCK.—If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this Act, or corresponding provisions of prior income tax laws, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

(11) PROPERTY ACQUIRED DURING AFFILIATION.—In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such

period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard to inter-company transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term 'period of affiliation' means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be determined in accordance with regulations prescribed under section 141(b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141(b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, applicable to such period.

(12) BASIS ESTABLISHED BY REVENUE ACT OF 1932.—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932 was prescribed by section 113(a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

(13) PARTNERSHIPS.—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any of the paragraphs (1) to (12), inclusive, of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partners shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

(14) PROPERTY ACQUIRED BEFORE MARCH 1, 1913.—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(D) in the case of stock (to the extent not provided for in the foregoing subparagraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of

the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921).

(2) SUBSTITUTED BASIS.—The term 'substituted basis' as used in this subsection means a basis determined under any provision of subsection (a) of this section or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(A) by reference to the basis in the hands of a transferor, donor, or grantor, or

(B) by reference to other property held at any time by the person for whom the basis is to be determined.

Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in paragraph (1) of this subsection shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) BASIS FOR DEPRECIATION.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) BASIS FOR DEPLETION.—

(1) GENERAL RULE.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection."

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 608

MILTON H. FRIEND, BERTHA F. LEVY AND ETHEL PACYNA, AS TRUSTEES OF THE TRUST ESTATE CREATED UNDER THE LAST WILL AND TESTAMENT OF HENRY FRIEND, DECEASED, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 180–192) is reported in 40 B. T. A. 768. The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 213–216) is reported in 119 F. (2d) 959.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 26, 1941 (R. 216–217). A petition for rehearing was denied June 13, 1941 (R. 217). The petition for writ of certiorari was filed September 12, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where petitioners, as testamentary trustees, become owners in fee through inheritance of certain tracts of realty subject to long-term leases, may they deduct from current rentals any amounts on account of depreciation or amortization on the alleged value of the lease contracts under Section 23 (1) of the Revenue Act of 1934?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, 48 Stat. 680:

> SEC. 22. GROSS INCOME.
>
> (a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities,

or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (U. S. C., Title 26, Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * * (U. S. C., Title 26, Sec. 23.)

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(5) *Property transmitted at death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. * * * (U. S. C., Title 26, Sec. 113.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolenscence of property used in the trade or business may be deducted

from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. * * *

ART. 23 (l)–2. *Depreciable property.*— The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. * * *

STATEMENT

This case involves income tax liability of testamentary trustees for the years 1934 and 1935 with respect to income from property formerly owned by the decedent. The facts found by the Board of Tax Appeals may be stated as follows:

At the time of the death of Henry Friend on August 1, 1932, he was the owner of two parcels of real estate. One of these, located at 6308-

6310 South Halsted Street, Chicago, was, in 1920, leased for a period of 99 years. The lessee paid the decedent $75,000 for the value of the improvements thereon. The lessee had the right to raze the buildings and to erect new buildings, the cost of which should be not less than $300,000. The lease also provided for an annual rental of $15,000 net from November 1, 1922, to October 31, 2019. This lease was acquired by the S. S. Kresge Company, and a supplemental agreement was entered into between Henry Friend, lessor, and S. S. Kresge Company, lessee, whereby the lessee was permitted to erect a building costing not less than $125,000, with a rental of $18,000 per year. This building was erected by the lessee in 1925 (R. 181).

The other parcel of real estate, located at 6312–6314 South Halsted Street, Chicago, was leased for a term of 25 years, beginning with 1924, to the F. W. Woolworth Company at an annual rental of $20,000. Subsequently, a second Woolworth lease was executed covering the demised premises from the end of the period covered by the first lease, for another period of 25 years, at an annual rental of $25,000. Pursuant to these two leases, the Woolworth Company erected a building upon the premises at a cost of $125,000 (R. 181–182).

It was the petitioners' contention that the estate of Henry Friend acquired upon his death, on August 1, 1932, leasehold estates upon the two properties, 6308–6310 and 6312–6314 South Hal-

sted Street, and also reversionary estates in respect of the properties; that since the Commissioner determined the values of these estates separately in the determination of the estate tax liability of the estate of Henry Friend, placing a very large value upon the leasehold estates and a very nominal value upon the reversionary estates, the estate is entitled to deduct from the capitalized value of the leasehold estates a reasonable amount for the amortization of those leasehold estates during the life of the leases and that the taxable income from the properties was the net rents received less reasonable amounts for amortization (R. 182). The deductions were denied by the Board of Tax Appeals and its decision was affirmed by the court below.

ARGUMENT

The petitioners do not dispute that if the decedent were still alive the rentals subject to tax could not be reduced by any deduction for exhaustion or depreciation of the leaseholds (R. 215). Their sole contention in essence is that the leaseholds became capitalized at his death and that then, for the first time, the rentals had to be applied against the new capital base, through allowances for depreciation or exhaustion, before they could be subject to tax.

Whether the future rentals may be capitalized at the time of decedent's death for the purpose of determining future gain or loss with respect to the leasehold has been recently considered by

this Court in *Hort* v. *Commissioner,* 313 U. S. 28, and that decision is dispositive of the issue herein.

In the *Hort* case, the taxpayer had inherited an office building in 1928 subject to an advantageous long-term lease. In 1933, he was paid a large amount by the tenant for cancellation of the lease. The Government sought to impose a tax upon the amount thus received in 1933. The taxpayer contended that the leasehold became capitalized in 1928, that what he had received in 1933 was simply a return of capital, and indeed that it was less than the amount of the new 1928 basis with the consequence that he sustained a deductible loss. This Court rejected those contentions and held that no portion of the amount received could be regarded as a return of capital for tax purposes. It was not (p. 31) "a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father."

Similarly here, no part of the annual rentals can be treated as a return of capital based upon capitalization of the leasehold at the decedent's death. The statutory provisions here invoked by petitioners were likewise available (as they appeared in a predecessor revenue act) in the *Hort* case, but were apparently not deemed to be of any controlling significance.

In asserting that (Pet. 20) the decision below means that no depreciation can ever be taken on *buildings* inherited, the petitioners clearly indicate that they have misconceived the basis for the

decision below. Buildings as such are depreciable property but the petitioners here were not entitled to such depreciation because of the provisions of the long-term leases under which the lessees were plainly entitled to the depreciation. The rental payments constituted income flowing from and incident to the ownership of the premises, and were properly subjected to income tax.

CONCLUSION

The decision below is correct and there is no conflict. The basic issue has been thoroughly explored in this Court's recent decision in the *Hort* case, and petitioners have suggested no reason for reexamination. The petition should be denied.

Respectfully submitted.

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OCTOBER TERM, A. D. 1941.

No. 608

MILTON H. FRIEND, BERTHA F. LEVY AND ETHEL PACYNA, AS TRUSTEES OF THE TRUST ESTATE CREATED UNDER THE LAST WILL AND TESTAMENT OF HENRY FRIEND, DECEASED,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONERS' REPLY BRIEF.

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONERS' REPLY BRIEF.

The "Brief for the Respondent in Opposition" is not responsive. It is not pertinent to the issue determined by the United States Circuit Court of Appeals nor that raised by the petition for certiorari.

The question as stated by respondent and the argument in respondent's brief relate to one of the several alternative theories suggested by the petitioners before the United States Board of Tax Appeals but abandoned in the oral argument before the United States Circuit Court of Appeals.

Stated simply, petitioners' position is as follows:

The petitioners are Trustees of the Estate of Henry Friend, who died on August 1, 1932. They acquired as part of the estate of the decedent certain real estate im-

proved and subject to long-term leases. At the time the leases had been made by the decedent, rent levels were substantially higher than on the date of his death. As a result, the date-of-death value of the property here in question, as determined for Federal estate tax purposes and as established in the hearings before the United States Board of Tax Appeals herein, was in excess of the value of the naked land, unimproved and unleased. In fact, the evidence established that there were two values involved in this property: the one, the value of the naked land, and the other, the capitalized value of the rentals payable under the lease over and above the rental value of the naked land. The existence of this excess value over the value of the land has not been contested. Respondent has conceded that, if the petitioners had purchased this property, land plus the interest of the lessors under the leases, at such date-of-death values, petitioners would be entitled to annual deductions for depreciation or amortization of the excess value over the value of the land.

The only issue left for consideration of the United States Circuit Court of Appeals was this question: Do the petitioners have any lesser right to such annual deductions for depreciation or amortization by reason of the fact that the land plus the lessors' interest were acquired by *inheritance* rather than by *purchase?*

It may be desirable to correct at the outset the erroneous references in respondent's brief (and also in the opinion of the Circuit Court of Appeals) to division of the property inherited into lessors' interest under the leases and reversions. Obviously, the inheritor of real estate subject to a lease could describe the property inherited in this manner. Both such interests could be separately valued. Petitioners believed, however, that such a separation might not be regarded as having sufficient reality for the practicalities of taxation and therefore adopted and urged be-

fore the Circuit Court of Appeals the more realistic concept referred to above, viz.: Did the naked land as of the date of death have a value different from that of the land in its improved and leased state? If the existence of the advantageous leases on the date of death established a value by reason of the rental "annuities" in the leases in excess of the value of the naked land, that excess value necessarily would terminate with the termination of the leases, and that value would, therefore, disappear by reason of the mere lapse of time. Petitioners were not and are not contending for the right to amortize the capitalized value of the *total* rentals under the leases without reference to the value of the land. That would be the gist of the lessors'-interest-plus-reversion argument referred to by the respondent. The petitioners are asking only the right to amortize that value on the date of death—under the Federal estate tax laws—which is in excess of the inexhaustible land and which will inevitably disappear with the extinction of the leases by lapse of time. This excess value the Commissioner concedes would be amortizable if it had been purchased for cash. The Circuit Court of Appeals appears to agree that basis exists with respect to this excess value for purposes of *gain or loss* even though inherited. Petitioners contend that it exists even though inherited for purposes of *depreciation or amortization.*

The situation is not distinguishable from that involved in the inheritance of land-and-buildings, which is merely another combination of exhaustible and inexhaustible assets expressly required to be separately valued and the exhaustible portion depreciated, in Article 23(l)-4 of respondent's Regulations 86 under the Revenue Act of 1934 quoted in the footnote.*

* ART. 23(1)-4. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113(a) and 114) * * * In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for

Perhaps a few examples will be helpful. Suppose two men purchase parcels of real estate A and B which are identical except that A is improved with a valuable building and B is bare. Plainly, A's purchase price (and hence basis) will normally exceed B's purchase price by an amount equal to the value of the building. It is known, however, that the building is exhaustible and will become worthless within a definable period, and at the end of that time A and B will be identical in every respect. Clearly the basis for these two identical parcels after the building becomes worthless should be the same and, hence, under the tax law, the value in A attributable to the exhaustible building is eliminated from the basis by depreciation during the building's life. Exactly the same rule would be applicable if, instead of being purchased, A and B were acquired by inheritance, the only difference being that the basis, both with respect to the land and with respect to the building, would be the value on the date of death rather than the purchase price.

Now, suppose that A is unimproved but has theretofore been leased under a long-term lease to a responsible lessee at rentals substantially in excess of the rentals which could be realized if a new lease were to be made at the time of acquisition. Here also, A's purchase price would be more than B's purchase price, since A's purchaser would be deriving greater revenue than B's purchaser. Similarly, if these properties are inherited, the date-of-death value (or basis) of A would be greater than that of B. Here again, however, the factor with respect to A which makes

example, buildings and land, the capital sum to be replaced is limited to an amount which bears the same proportion to the lump price as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.

The fact that the depreciable portion of the property here involved is intangible (right to receive rents) rather than tangible (buildings) as mentioned in the above example, is irrelevant. Article 23(l)-3 of Regulations 86 provides, in part, as follows:

ART. 23(l)-3. *Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance.

its basis greater than the basis of B is the lessor's interest under the lease, which will become worthless within a period ascertainable at the date of acquisition. At the end of this period, again A and B will be identical, and at that time their bases should be identical. The excess in A's value over B's value must be written off by depreciation during the life of the item of exhaustible property representing the excess value, whether tangible, as in the case of the building, or intangible, as in the case of the lease. In the one case the tangible improvement is in a sense an incident of the fee. Similarly, in the case of the lessors' interest under the lease, it may be regarded as an incident of the fee. But in both cases these exhaustible incidents are readily susceptible of separate valuation for purposes of allocation of purchase price or of date-of-death values.

In the case at hand, at the date of death there existed not only such advantageous leases representing a rental value over the naked land, but in addition, the land was actually improved with valuable buildings. In addition, the evidence before the Board of Tax Appeals clearly established these separate date-of-death values for the land and the excess value for the exhaustible rights against the lessees. There is not a word in respondent's brief which mentions these facts.

Let us examine respondent's brief.

On page 2 respondent purports to state the "question presented" but omits the all-important distinguishing fact that in this case the long-term leases represented, at the date of the decedent's death, a value in excess of the value of the naked land on that date, and omits also mention of the fact that the property in the lease contracts with respect to which depreciation or amortization is sought is this excess exhaustible value.

On pages 2 to 4, in quoting pertinent provisions of the law and regulations, respondent omits mention of Section

114(a) of the Revenue Act of 1934, the crucial section which makes Section 113(a)(5) of that Act (which respondent quotes) applicable for purposes of *depreciation* as well as for purposes of *gain or loss.*

Pages 4 to 6 of respondent's brief erroneously state as petitioners' contention the alternative position abandoned before the Circuit Court of Appeals and not here involved. Attention is particularly directed to the paragraph beginning at the bottom of page 5 and carrying over to page 6. This paragraph (except for the last sentence) is virtually a quotation of the first few sentences of the opinion of the Board of Tax Appeals herein (R. 182), which paraphrased this abandoned alternative argument. No mention is made in respondent's brief of petitioners' primary position, which is paraphrased in the immediately succeeding paragraph of the opinion of the Board of Tax Appeals herein as follows (R. 183):

> "In the alternative they make the contention that the business depression was at a very low point on August 1, 1932; that on the [that] date a reasonable and fair rental for the land at 6308-6310 South Halsted Street, unimproved and unencumbered by any lease, would have been $14,000 per annum net to the owner [under] a lease of 30 years or more, sufficient to make it worth while for the lessee to erect a suitable improvement; and that on the same date a reasonable and fair rental for the land at 6312-6314 South Halsted Street, unimproved and unencumbered by any lease, would have been $12,500 per annum net to the owner under a least [lease] of 30 years or more. They then contend that the excess rental receivable by the estate under the terms of the leases was amortizable over the terms of the leases. Upon this basis they contend that the excess rental receivable on the Kresge property had a value on August 1, 1932, or [of] $49,940 and on the Woolworth property $67,575 plus the present value of an annuity of $12,500 per year for 25 years commencing 16 years and 5 months after August 1, 1932, the life of the second Woolworth lease, or

> $37,760. Upon this alternative basis they claim that the amortization deductible in each of the years 1934 and 1935 was $5,600."

Obviously if, as the Board stated and the evidence conclusively shows, a reasonable and fair rental for the inexhaustible land of the Halsted properties on the date of the decedent's death totalled $26,500 a year and the actual rentals under the exhaustible leases which the petitioners inherited, as stated by the Board (R. 182) and the respondent (brief, page 5), was between $38,000 and $43,000 a year, there was property of value at the date of the decedent's death represented by the definite right to receive up to $16,500 a year in excess of what could have been realized from the inexhaustible ground, and the life of this property as well as its value was definitely known.

The bulk of respondent's argument (pages 6 to 8) is simply a reliance upon the recent decision of this court in *Hort* v. *Commissioner*, 313 U. S. 28, 85 L. Ed. 706 (3/31/41). The *Hort* case did not involve and did not decide any issue related to the issue here involved. In the *Hort* case the taxpayer's father had entered into a lease on August 31, 1927 covering certain bank premises in New York City. The father died on March 7, 1928, devising the premises, together with the lease, to the taxpayer. Thus, the valuation date for determining the basis to the taxpayer of the premises-and-lease in the *Hort* case was 1928, when the lease may have been advantageous to the lessee rather than the lessor, and certainly could not have represented excess value over the rentable value of the premises at the time of the father's death. The important fact is that nowhere in the record or briefs in the *Hort* case before this Court is there any suggestion that the value *on the date of the father's death* of the premises-and-lease was in excess of the value on that date of the premises alone.

Perhaps the difference between the *Hort* case and the

present case can be illustrated by a further example. Suppose a taxpayer receives by inheritance a parcel of land on which is a building which has no economic value at the time of the decedent's death, or, in other words, suppose that the value of land-and-building is equal to or less than the value of the land alone. Here the building has no basis and is not subject to depreciation. Suppose, on the other hand, that the building has substantial value at the date of decedent's death, or, in other words, that the value of the land-and-building is substantially in excess of the value of the land alone. Here the building has a basis equal to its value over and above the value of the naked land and is depreciable to that extent. To say that the decision in the first example is controlling in the second example would be absurd. Yet, such an argument is indistinguishable from the argument which respondent attempts to make based upon the *Hort* case.

In his discussion of the *Hort* case on page 7 of his brief, respondent states that the lease involved in that case was "advantageous." Of course, it was advantageous in 1933, when the lessee paid a substantial amount to be relieved from its burdens. 1933, however, was not the valuation date for purposes of determining *basis*. That valuation date was March 7, 1928, barely six months after the execution of the lease, and there was no showing or attempt to show that the lease was advantageous to the lessor on that date. In the present case, however, the critical valuation date for the purpose of determining basis (date of death) is August 1, 1932, and the record abundantly established that on that date the leases were advantageous and that the lessor's interests under the leases had substantial values in excess of the value of the naked land.

The issue in the *Hort* case was simple. The sole contention made by the taxpayer in that case was that at the time of the cancellation of the lease the taxpayer had in

contemplation the receipt, for approximately thirteen years thereafter, of rent with respect to the premises in question in excess of the then rentable value of the land. In view of the high real estate values on the basic valuation date in that case, namely, 1928, it was not contended and could not have been contended that if these rents had actually been received they would not have constituted fully taxable income. The sole argument which the taxpayer did make and could make was that the receipt in advance of a lump sum for termination of the lease, which was less (even when augmented by the then rental value of the premises) than the income which the lease contract provided to be payable over a period of years, constituted a loss. As this Court emphasized several times in its opinion, this argument was denied solely on the ground that the advance payment was simply a substitute for payments in the future which would admittedly constitute income. This Court stated (85 L. Ed. at 709):

> "The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but to that extent he was relieved of the duty to pay income tax. Nothing in Sec. 23(e), 26 U. S. C. A. Int. Rev. Acts, 1940 ed. p. 490, indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by *the amount of income he failed to realize.*" (Italics added.)

The Board of Tax Appeals, whose decision was affirmed by this Court in the *Hort* case, rested its conclusions upon the fact that the lease had no basis and that no value was shown for the lease *as of the date of death* in that case over and above the value of the land and building. The Board stated as follows (39 B. T. A. 922, 925-926 (1939)):

> "The petitioner has failed to prove any figures from

which a loss could be computed. A loss from the disposition of property is computed for income tax purposes by deducting the amount realized from the adjusted basis. The amount realized from the cancellation of the lease was $140,000. Basis is always cost or some substitute therefor authorized by the revenue act. *Where, as here, property was acquired by bequest in 1928, the basis would be the fair market value of the property in 1928. The evidence does not show any separate basis for the lease in question in the hands of this petitioner or that the lease had any value in itself at the time that the property was acquired by this petitioner.*" (Italics added.)

The plain implication of this language is that if the evidence had shown that the lease had separate value on the basic valuation date, namely, the date of death, it would have had a separate basis for tax purposes and such basis would be taken into consideration in determining gain or loss. The same point of view is indicated in the Commissioner's brief before this Court in the *Hort* case in which it is stated, at pages 6-8:

> "Leases may or may not, depending upon the circumstances of each case, be property which is to be considered as capital in the hands of the taxpayer. A taxpayer who paid $100,000 for an assignment of the lessor's interest in a lease would have a capital investment of $100,000 in that lease; if it were cancelled the next day in return for a payment by the lessee of $100,000, the taxpayer would obviously have realized no gain. On the other hand, if a taxpayer makes a lease on his own property one day and several days later agrees to cancel the lease, or assigns the lease, in return for the payment to him of $100,000, he obviously realizes income of $100,000 because the lease does not represent capital in his hands. He has not spent anything to acquire the lease and the rental obligation cancelled or assigned has not been received and reported as income by him.
>
> The present case must be decided in the light of these principles. The taxpayer may prevail only if he can

show that the cancelled lease was property which, in his hands, represented capital. This showing he cannot make. The lease was plainly not capital in the hands of petitioner's father, and it was not transmuted into capital upon the father's death in 1928. *The record does not show whether in 1928 the lease had any value;* whatever value it might have had was not reported separately in the estate-tax return but was simply reflected as part of the $650,000 valuation placed upon the land and building. Thereafter the tax basis of the property in the hands of petitioner was $650,000; for purposes of income-tax accounting, however, that tax basis is ascribed entirely to the land and building, which alone are considered as capital assets, the leases being treated as purely income items with a tax basis of zero.

Furthermore, petitioner has failed to show that in 1928 the Irving Trust Company lease, to commence in 1932, was of any value at all. Consequently, even if the lease be treated as a capital asset, it would still be property with a tax basis of zero and its disposition would therefore still result in gain to the full extent of the consideration received." (Italics added.)

In the present case the evidence of excess value in the leases is clear, is not contested by the respondent, and is assumed both by the Board of Tax Appeals and the Circuit Court of Appeals. Furthermore, in the present case, in contrast to the *Hort* case, the lease and land were separately valued for purposes of the federal estate tax (R. 182).

One of the cases repeatedly relied upon by the Commissioner before this Court in the *Hort* case and relied upon by the Circuit Court of Appeals for the Second Circuit in *Warren Service Corporation* v. *Helvering*, 110 F. (2d) 723 (C. C. A. 2d 1940), upon which the decision of the Circuit Court of Appeals in the *Hort* case was summarily based, is *Josey* v. *Commissioner*, 104 F. (2d) 453 (C. C. A. 10th 1939). In the *Josey* case the facts were similar to those in the *Hort* case with one additional important fac-

tor, viz., the taxpayer acquired the lessor's rights under the lease in question by purchase for $50,000. This $50,000 the taxpayer wrote off by depreciation or amortization deductions year by year, and this practice was approved by the Commissioner and the Circuit Court of Appeals. The Circuit Court of Appeals stated (104 F. (2d) 455-56):

> "Under Section 23(a) of the Revenue Act of 1934, 48 Stat. 688, 26 U. S. C. A. Sec. 23 (a), and Art. 23(a)(10), Tr. Rep. 86, Josey is entitled to an amortization deduction of an aliquot part of the $50,000 paid by him for one-half interest in the lease each year until the entire cost has been amortized. * * *
>
> * * * * *
>
> Since Josey will eventually receive through amortization deductions the entire cost of $50,000, the disallowance of a loss deduction will result in no injustice to him."

Thus, not only does the present case lack the one essential element upon which the *Hort* decision was based (namely, advance payment in lieu of income) and include the one essential element which the *Hort* case lacked (namely, excess value in the exhaustible leases on the basic valuation date—date of death), but also one of the principal cases upon which the respondent relied in the *Hort* case, namely, the *Josey* case, is in conflict with the decision in the case at bar, and for this reason, if for none other, the writ of certiorari should be granted.

Contrary to the statement on page 7 of respondent's brief, the statutory provisions here invoked were not available in the *Hort* case because there was no element of excess exhaustible value in the lease in the *Hort* case on the date of the decedent's death, which, in that case as well as in this case, was the basic valuation date.

In the last paragraph of respondent's brief, fleeting mention is made for the first time of the real issue set forth in petitioners' petition for certiorari, namely, that the Cir-

cuit Court of Appeals has decided this case upon the holding that Section 113(a)(5) provides a basis only for gain or loss and not for depreciation. No reference is made to the opinion of the Circuit Court of Appeals to support respondent's contention that the petitioners "have misconceived the basis for the decision below." No explanation is made of the second paragraph on R. 215, in which the Circuit Court of Appeals stated that the petitioners may not rely upon Section 113(a)(5) of the Revenue Act of 1934 to furnish a basis for amortization because the basis provided in that section is merely a basis for gain or loss.

Conclusion.

It can serve no useful purpose to review herein the authorities cited in petitioners' brief in support of their petition for certiorari. Neither these authorities nor indeed any of the arguments presented by petitioners have been considered in respondent's brief. The only authority cited by respondent, namely, *Hort* v. *Commissioner*, 313 U. S. 28, 85 L. Ed. 706 (3/13/31), did not involve the fundamental facts involved herein, namely, excess exhaustible values on the date of death, and did not involve, expressly or implicitly, the position urged by the petitioners herein.

It is respectfully submitted that, as stated in the petition for certiorari, the decision of the United States Circuit Court of Appeals is in conflict with the applicable decisions of this Court and other Circuit Courts of Appeals and in direct contradiction of the unambiguous language of the appropriate statute. The writ of certiorari should be granted.

Respectfully submitted,

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